

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matters of)
)
Ameritech Corporation Telephone Operating)
Companies' Continuing Property Records)
Audit)
)
Bell Atlantic (North) Telephone Companies)
Continuing Property Records Audit)
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Bell Atlantic (South) Telephone Companies)
Continuing Property Records Audit)
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BellSouth Telecommunications' Continuing)
Property Records Audit)
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Pacific Bell and Nevada Bell Continuing)
Property Records Audit)
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Southwestern Bell Telephone Company's)
Continuing Property Records Audit)
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US WEST Telephone Companies' Continuing)
Property Records Audit)

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**COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY,
PACIFIC BELL AND NEVADA BELL**

**SOUTHWESTERN BELL TELEPHONE COMPANY
PACIFIC BELL
NEVADA BELL**

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Summary*

By seeking public comment on fundamental questions concerning the audit reports, the FCC acknowledges that it is not even sure whether these audit reports are right, and if so, what ratemaking and other impacts, if any, the auditors' conclusions could have under price cap regulation. These sort of matters of general applicability should be decided before beginning such a costly and burdensome activity as these audits rather than at the end of the process.

In their responses, the RBOCs raised many of the same concerns with these audits that are the subject of the issues in the NOI. There were serious problems with the way the auditors conducted these audits, including fundamental flaws in the auditors' sampling and audit procedures. Ernst & Young LLP ("EY") found the following four significant deficiencies:

(1) **Lack of Two-Way Audit.** First, if the auditors wanted to accurately quantify the missing equipment, they should have conducted a two-way audit, instead of only checking to see whether an item in the CPR could be found in the central office. In effect, they only looked at "half of the equation."

(2) **Sample Not Designed To Estimate Dollar Values Accurately.** Second, the auditors designed the audit to measure the proportion of items not found, instead of the dollar value of missing items. The auditors' sample design causes the range of dollar estimates to be highly questionable and subject to significant uncertainty as evidenced by the huge size of the dollar confidence intervals.

(3) **Wide Margins of Error.** Third, the margins of error are very imprecise, and when they are corrected, using the SBC LECs' data, the margins of error are so wide that the results provide little or no useful information concerning the dollar value of property not found, especially when one considers that, as a statistical matter, no single value within the range is any more likely to be correct than any other.

(4) **Biased Estimates.** Fourth, there were many sources of bias that cause further

* The abbreviations in this Summary are defined in the body of these Comments.

inaccuracy in the audit results. Sources of this bias include substitution of items for undesirable ones and weakness in the audit controls.

As a result of sampling deficiencies, the auditors are unable to produce accurate estimates of the value of items alleged to be "not found." For example, the range of values in the estimate for Pacific is \$433 million, that is, somewhere between \$282 million and \$716 million. In view of the fact that no single value within these wide ranges is any more likely than any other, these estimates are too imprecise to justify any action. Due to these deficiencies in the sampling and audit procedures, EY concludes that "the amounts reported by the FCC as overstated investment are unsound and cannot be fairly relied upon." In fact, when one considers the evidence that the SBC LECs submitted showing the existence of dozens of items that the auditors deemed "not found," the low end of the 99% confidence interval would be below zero for both SWBT and Pacific.

There are also serious problems with the auditors' rescoring standards described in the Rescoring Public Notice released on April 7, 1999. The Rescoring Public Notice claims that the evidence submitted by the RBOCs "often did not meet the standards to warrant rescoring." It is fundamentally unfair and unreasonable for the auditors to expect the evidence to meet standards that are released for the first time seventeen months after the fact. On this basis alone, the auditors' conclusions should be rejected.

While the auditors recognize the importance of direct physical examination in reaching their conclusion, their procedure was inconsistent because they did not return to any locations to perform any further physical examinations after receiving the RBOCs' evidence showing that items originally scored "not found" actually existed. When presented with the companies' proof that items existed, the auditors made no effort to communicate with the companies or to do any further investigation.

If the auditors truly considered these to be deficiencies at the time, the SBC LECs would have expected the auditors to communicate these deficiencies to the SBC LECs at some point during the several months during which this evidence was submitted to the auditors. Instead, the SBC LECs did not discover the results until they received the draft audit reports in July 1998 and even then they could only guess why the auditors rejected virtually all of their evidence. The auditors did not perform this audit consistent with Generally Accepted Auditing Standards("GAAS") because they did not consider all the evidence or perform all the procedures necessary under the circumstances. As EY explains, a "critical element of auditing is timely and frequent interaction with representatives of the company being audited to attempt to address issues raised in the audit." If the auditors were not going to accept the evidence submitted by the companies, then they should have discussed this with company personnel and performed additional procedures necessary to evaluate the companies' evidence. In any event, the auditors did not perform sufficient audit procedures and ignored relevant information.

The rescoring standards were also unreasonable and narrow. For example, the auditors rejected documentation that was not in the exact form required by its standards and documentation with nonmatching details despite reasonable explanations of the differences. While most items had very little chance of being rescored, embedded items originally scored "not found" had no possibility at all of being rescored. Besides, the auditors did not consistently follow their own standards. For example, even when exactly the same or very similar documentation was furnished on two different items, the auditors reached opposite conclusions.

In view of the serious flaws in the auditors' sampling methods and audit procedures, these

audits cannot serve as a basis to require any corrective action. The audit reports produce extremely broad and imprecise estimates of the dollar value of allegedly "not found" equipment and ignore the evidence submitted by the companies. Besides, as the FCC requires ILECs to maintain CPRs in excessive and unnecessary detail, there must be some reasonable standard of materiality for evaluating compliance other than perfection or near-perfection. Further, the auditors used an unrealistically narrow and unprecedented interpretation of the rules in conducting these audits. Corrective action is not justified by these audits because the results are not reliable and the true degree of error in the CPR is not material.

Just as these audits do not justify corrective action generally, they also do not provide any rational basis for the auditors' recommended write-offs. There is simply no statistically valid basis to conclude that the books of any RBOC are overstated by hundreds of millions of dollars, as alleged. Aside from the lack of justification, there are other problems with the write-off recommendation. First, writing off an extrapolated amount based on statistical analysis is contrary to Section 32.2000(d)(1)'s requirement that all retirements refer to the specific records in the CPR from which the required cost was taken. As a result, the companies would no longer be able to reconcile their CPRs with their books of account. Second, this recommendation is inconsistent with the reasoning of the second recommendation of complete inventories, in support of which the auditors claim that "the only way to ensure a CPR line-item is correct is to examine the corresponding equipment items." Third, this recommendation does not consider all the changes that have occurred in the last two and a half years as a result of the RBOCs' own physical inventory programs, such as the SBC LECs' SAVR process, periodic inventory programs and routine

construction and replacement activity. For example, the auditors recommend that SWBT write off the \$924 million of undetailed investment that SWBT had as of June 1997, which fails to consider that the SAVR inventory process has already reduced this undetailed investment to about \$100 million. Obviously, it would be impossible to write off \$924 million when only \$100 million remains as undetailed. Fourth, write-offs as substantial as those recommended by the auditors should not be required where, as here, there has not been a fair consideration of all of the circumstances, such as the evidence submitted by the RBOCs.

Requiring a write-off of the undetailed investment also would be contrary to the FCC's December 1968 ruling that allowed the RBOCs to implement the mechanized CPR for hardwire equipment on a "going-forward" basis, that is, for plant added after the start of the plan in each region. The vast majority of the undetailed investment represents equipment that was placed in service before each RBOC implemented the mechanized CPR in a particular state or region. Thus, undetailed investment has been permitted by the FCC for 30 years. Applying cost/benefit considerations, the FCC should not impose onerous requirements to address the undetailed investment. Instead, it should recognize efforts such as those of the SBC LECs in identifying and eliminating this undetailed investment via the SAVR inventory process.

The audits should not be used as a basis to require any of the RBOCs to incur substantial, additional costs to inventory all of their central office equipment, as the auditors recommend. The benefits of such inventories are minimal or nonexistent. Delayed or omitted retirements discovered in any physical inventory would neither benefit nor harm ratepayers. In any event, the RBOCs' existing internal controls and procedures should be considered sufficient, such as the RBOCs'

inventories on a rotating basis over a period of years and the SBC LECs' SAVR inventory process. In the case of the SBC LECs, the auditors' recommended inventories are totally uncalled for, as they would duplicate the SBC LECs' SAVR process, in which independent contractors perform a comprehensive, two-way inventory of all hardwire equipment in each central office.

Given that the auditors did not even obtain a sufficient understanding of the companies' internal controls as part of these audits, as required by Generally Accepted Auditing Standards ("GAAS"), it is hard to see how they have any basis to recommend an independent audit of those controls. While such an independent audit is not justified on the basis of these audits, the SBC LECs are willing to consider reasonable, cost-effective methods of enhancing their internal controls, provided there is some material benefit in doing so. Given that the existing CPR requirements are excessively detailed and outdated, then, provided any review of internal controls is warranted after considering a sample review of the SAVR inventory process, the SBC LECs would be willing to consider engaging their existing independent auditor for the dual purpose of reviewing their internal controls as well as the FCC's CPR requirements. The purpose of reviewing the FCC's CPR requirements would be to recommend methods of streamlining and updating them.

Account balances and CPRs no longer play a role in ratemaking for price cap carriers, especially now that the FCC has eliminated sharing completely and also the low-end adjustment on a holding-company-wide basis for any price cap carrier that adopts any of the *Pricing Flexibility Order's* options in any of its markets. Even under rate-of-return regulation, delayed or omitted retirements would have little, if any, impact on ratemaking over time. The lack of impact is due to a combination of several factors explained in the Declaration of Marla Martin attached to these

Comments. Mainly, the retirement of an asset does not have any impact on the net plant balances and remaining life depreciation rates are self-correcting in nature. Thus, revenue requirements would not change materially and omitted or delayed retirements would not have any impact under rate-of-return regulation or under the rate-of-return backstop mechanisms of price cap regulation.

While there would not be any impact on the rate-of-return rates going into price caps in 1990, if we assume *arguendo* that there could be some impact, it would be inconsistent with the FCC's price cap regime to re-initialize the current price caps, especially now that the FCC has completely severed the connection between the prices customers pay and the costs that price cap carriers incur. To seek rate-of-return perfection long after the deadline for any challenges to 1990 rates would be inconsistent with the FCC's rejection of similar requests for revisions and further rate-of-return proceedings at the time. But, if the FCC were going to consider such adjustments, it would also need to address imperfections that caused the rates going into price caps to be too low.

It is important to understand that assets cannot be retired without identifying all of the individual units being retired, i.e., on the basis of a statistical extrapolation. Any individually identifiable units that cannot be found during a physical inventory should be handled as normal retirements. Just as a write-off would be improper, the Bureau's suggestion that these could be handled as extraordinary retirements is also wrong. These audits do not present a situation for which the extraordinary retirement rule was designed, such as when significant utility assets are destroyed by fire or other calamity. Nor do these audits satisfy the requirements of Section 32.2000(g)(4). First, delayed or omitted retirements resulting from inventories are not unusual. It is common to expect a number of inventory adjustments and retirements in connection with physical inventories that

utilities routinely perform. Second, one cannot say that these types of retirements are not reflected in depreciation studies or considered in the three-way meeting negotiation process. Among other reasons, it is extremely unlikely that such retirements would have altered any of the results of the give-and-take of that negotiation process. In any event, considering an RBOC's large depreciation reserves, there would not be a significant impact on any of the depreciation reserves.

There is also no reason to expect any causal relationship between inaccurate account balances and the results of the forward-looking cost models for universal service support and UNE prices. The forward-looking method of making these calculations generally do not rely on the ILEC's actual, embedded book costs. Consistent with the SBC LECs' experience, Ameritech shows that there are only two factors in its UNE cost studies that are affected by account balances: the maintenance and tax factors. However, if account balances have been overstated in recent years, as the auditors allege, these two cost factors and UNE prices were lower than they would have been otherwise. Thus, correction of any overstatements in the account balances would raise the rates paid by UNE customers.

Similarly, under the FCC's method of calculating the depreciation reserve deficiency, significant retirements of assets prior to them being fully depreciated would increase the size of this deficiency.

The FCC should consider these audits in a broader context that takes into account factors such as whether they are consistent with the cost/benefit analysis required by Section 11 of the 1996 Act and how they compare to the FERC's less burdensome asset tracking requirements. Increasing the burden of these regulations via comprehensive audits and unprecedented rule interpretations does

not make sense long after abandonment of rate-of-return regulation. Considering that these audits serve no useful purpose, they were performed in a manner that unduly intensified the burden of the CPR requirements at a time when the 1996 Act has made the streamlining and simplification of such outdated regulation a priority for the FCC. The FCC does not need such excessively detailed property records to perform its regulatory functions. Rather, the FCC should use this opportunity to consider methods of simplifying and updating these requirements.

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**COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY,
PACIFIC BELL AND NEVADA BELL¹**

Introduction

In 1994, four years after the FCC abandoned rate-of-return regulation in favor of price cap regulation for large Local Exchange Carriers ("LECs"), the FCC conducted a series of audits of the Continuing Property Records ("CPRs") of the Regional Bell Operating Companies ("RBOCs") including the SBC LECs. While the Common Carrier Bureau ("Bureau") prepared a consolidated report on these 1994 audits, it was never

¹ Southwestern Bell Telephone Company ("SWBT"), Pacific Bell and Nevada Bell ("SBC LECs") are filing these Comments pursuant to the Commission's *Notice of Inquiry*, 14 FCC Rcd 7019 (1999) ("NOI"), FCC 99-69 in the above-captioned proceeding released on April 7, 1999.

made public or furnished to any of the RBOCs.² In fact, some of the RBOCs did not find out the specific results of the 1994 audits until they received some of the details in the draft reports of the current audits four years later in July 1998.

Without ever concluding the 1994 audits, the Bureau initiated the current audits in 1997 using an entirely different approach. For example, instead of using a purely judgmental sampling process, the Bureau attempted to use a complex, two-stage stratified sampling process to select a sample of 36 pieces of equipment at numerous RBOC central office locations across the country. Over a period of two months in 1997, the FCC auditors fanned out across the SBC LECs' territory to conduct costly field audits on short notice at 64 central offices, spending typically no more than six to eight hours searching for the selected pieces of complex, technical equipment at each office. In late 1997, the FCC auditors furnished their preliminary results to the SBC LECs and, without any explanation, requested the companies' "perspective on the findings" within less than two-weeks.³ Considering that the total number of items in dispute at that time was almost 500, the SBC LECs were not able to furnish rebuttal on specific items within two weeks, but over the next several months, the SBC LECs spent thousands of hours investigating many of the items not considered "found" in the Bureau's preliminary results and furnished over 200 detailed write-ups proving the existence of the equipment using supporting records, data and documentation. Despite all of the evidence submitted by the

² SWBT Audit Report, n. 22. Please note, however, that Pacific Bell did receive two letters that included some of the results of the 1994 audit of Pacific Bell's central office equipment. *See, e.g.*, Letter dated April 11, 1994 from Jose-Luis Rodriguez, Chief, Audits Branch, FCC to Sheryl L. Herauf, Director, Federal Regulatory Accounting, Pacific Telesis Group – Washington. Pacific Bell responded with specific plans of action that addressed the FCC auditors' concerns. *See* Letter dated May 9, 1994 from Sheryl Herauf, Director, Federal Regulatory Accounting, Pacific Telesis Group – Washington to Jose Luis Rodriguez, Chief, Audits Branch, FCC.

³ *See, e.g.*, Letter dated Nov. 18, 1997 from Jeffery D. Stover, FCC Auditor, to B. Jeannie Fry, Director Federal Regulatory, SBC.

SBC LECs, the auditors never performed additional steps as required by auditing standards to confirm or understand the evidence submitted. The FCC's auditors rejected all but 35 of these write-ups, as the SBC LECs discovered for the first time when they received draft reports in July and December 1998. The SBC LECs had no idea precisely what standards the FCC auditors were applying to the write-ups the SBC LECs had submitted. In fact, the FCC auditors had not furnished a set of general standards until release of the Public Notice⁴ on the subject on April 7, 1999, some two years after the audit began.

Now, the NOI seeks comment on a number of fundamental questions relating to the validity of the auditors' findings, the validity and reasonableness⁵ of their audit procedures, whether accounting corrections are required, the merit of the audit reports' recommendations and the ratepayer impact of the audit results. Further, the NOI seeks comment on the evidentiary standards that the auditors claim to have applied to reject evidence such as the vast majority of SBC LECs' 200+ write-ups, which standards were disclosed to the SBC LECs for the first time when they were publicly released on April 7, 1999.⁶ Apparently, this release of written standards after the fact was in response to

⁴ Public Notice, "The Accounting Safeguards Division Releases Information Concerning Audit Procedures for Considering Requests by the Regional Bell Operating Companies to Reclassify or 'Rescore' Field Audit Findings of Their Continuing Property Records." DA 99-668, released April 7, 1999 (the "Rescoring Public Notice")

⁵ The reasonableness of the auditors' audit procedures is addressed in the context of the current CPR requirements. From a more general perspective even if the auditors had performed their work perfectly, these audit methods would still be unreasonable because the requirements are several times more onerous than they need to be in the current regulatory and competitive environment.

⁶ See Rescoring Public Notice, *passim*.

complaints from the SBC LECs⁷ and similar complaints from other RBOCs⁸ that they had never been furnished any written guidelines or standards and that the auditors' scoring and re-scoring suffered from numerous inconsistencies.

As part of their description of these and numerous other inconsistencies and flaws in these audits, the SBC LECs will elaborate to some extent on those that were identified in the SBC LECs' Response published with the audit reports.⁹ Not the least of these deficiencies is the obvious lack of planning of this audit, of which the NOI itself is a prime example. It is astonishing that the Bureau would devote so much time and effort, and require the RBOCs to devote equal or greater resources, to such comprehensive audits without knowing whether the results of the audits would have any practical utility. To leave that assessment of the value of an extremely costly and burdensome activity to the tail end of the entire process is irresponsible. However, similar "cart-before-the-horse" behaviors can be seen throughout the course of these audits, such as the failure to design the sampling method to produce accurate estimates of dollar values and, as an afterthought, the attempt to salvage the completely unreliable results with an ill-defined statistical method from the Bayesian family.

⁷ Joint Response of Nevada Bell, Pacific Bell and Southwestern Bell Telephone Company, filed Jan. 11, 1999, at 21-24 (the "SBC LECs Response") 21-24. The SBC LECs Response was published along with the Audit Report released Mar. 12, 1999. Other RBOCs' responses released on the same date will be cited herein in the same fashion (e.g., "Bell Atlantic Response")

⁸ See, e.g., Ameritech at 5-8 and Appendices A-O at 2-6 and A-4 at 1-7.

⁹ *Id.*

I. The Audit Results Are Unsound and Unreliable Due to Fundamental Flaws in the Auditors' Sampling and Audit Procedures (Issue 1).

A. Significant Deficiencies Plague the Audit Results, Especially the Dollar Estimates.

In Issue 1, the NOI seeks comments on the validity and reasonableness¹⁰ of the auditors' statistical sampling methodologies, including several subtopics such as the confidence intervals and the audit procedures. When the SBC LECs received the draft reports in July 1998, they retained the services of statisticians at Ernst & Young LLP ("EY") to review the methods used by the FCC auditors in these CPR audits. Based on the draft audit reports, EY prepared a report on each of the two audits of the SBC LECs. A copy of EY's report on Pacific Bell's CPR (the "EY Pacific Report") is attached to these Comments as Exhibit "A". As the EY reports explain in detail, there are four significant deficiencies in the methodologies used by the FCC auditors:

(1) Lack of Two-Way Audit. First, if the auditors wanted to accurately quantify the missing equipment, they should have conducted a two-way audit, instead of only checking to see whether an item in the CPR could be found in the central office. In effect, they only looked at "half of the equation."¹¹

(2) Sample Not Designed To Estimate Dollar Values Accurately. Second, the auditors designed the audit to measure the proportion of items not found, instead of the dollar value of missing items. The auditors' sample design causes the range of dollar estimates to be highly questionable and subject to significant uncertainty as evidenced by the huge size of the dollar confidence intervals.

¹⁰ The reasonableness of the auditors' audit procedures is addressed in the context of the current CPR requirements. From a more general perspective even if the auditors had performed their work perfectly, these audit methods would still be unreasonable because the requirements are several times more onerous than they need to be in the current regulatory and competitive environment.

¹¹ Bell Atlantic Response at 9.

(3) **Wide Margins of Error.** Third, the margins of error are very imprecise, and when they are corrected, using the SBC LECs' data, the margins of error are so wide that the results provide little or no useful information concerning the dollar value of property not found, especially when one considers that, as a statistical matter, no single value within the range is any more likely to be correct than any other.

(4) **Biased Estimates.** Fourth, there were many sources of bias that cause further inaccuracy in the audit results. Sources of this bias include substitution of items for undesirable ones and weakness in the audit controls.

EY describes the cumulative impact of these deficiencies as follows: "Given these errors and biases, the amounts reported by the FCC as overstated investment are unsound and cannot be fairly relied upon."¹²

Unfortunately, the SBC LECs cannot furnish a number that would represent an accurate estimate based on these audit results. Mainly, it is impossible to correct the audits' sampling and other problems after the fact. For example, given that the auditors estimate that the value of missing equipment at Pacific Bell is \$499.1 million \pm \$216.5 million, the range of values in the auditors' estimate is \$433 million, which is almost as large as the midpoint of the estimate's range. In fact, it is almost 90% of the auditors' \$499 million estimate. An estimate with such a wide range is not useful at all.

The range of the dollar estimate is so huge because of the way the auditors designed the audit. For example, after the auditors divided the central offices into eleven strata (in the SBC LECs' case), they did not select a sufficient number of central offices in each stratum.¹³

Even though one cannot produce a number that represents a corrected estimate that remedies all of the deficiencies in the auditors' sampling and other audit procedures,

¹² SBC LECs' Response, Attachment B, at 3.

¹³ See EY Pacific Report at 6. See also US WEST Response at 16.

it is clear that the auditors' estimates of the so-called "missing" equipment are significantly overstated for several reasons.

First. The failure to perform a two-way audit ignores equipment in the field that was not listed in the CPR. The result is that the audit reports' quantification of "missing" investment systematically overstates any value. That is, the auditors were looking for any equipment that might represent an overstatement while ignoring any equipment that would represent an understatement of the investment in the CPR. As the Deloitte & Touche statistician used by US WEST explains,

When tests are performed for both overstatement and understatement, understatement errors are often used to partially offset overstatement errors and therefore reduce the size of the resulting overstatement estimate.¹⁴

In fact, as part of the Statewide Asset Validation and Retirement ("SAVR") process, the SBC LECs have conducted two-way audits of its central offices and have found equipment that had not been posted in the CPR database. For example, as of August 31, 1999, SWBT's SAVR process had identified almost \$120 million of equipment that was not listed in the CPR. Further, in a two-way audit process, the auditors would not have counted an item as "not found" if the total quantity of like items at a location matched the total quantity in the CPR.¹⁵

¹⁴ US WEST, Attachment 2, Letter from Ann Thorton, Deloitte & Touche, dated Aug. 18, 1998, at 3.

¹⁵ A response to an inquiry from Congress attempted to explain why the FCC auditors had not conducted a two-way audit, although this appears to be an after-thought, given that the audit reports say nothing about this. This letter states, "Carriers have ample incentive to book all of these costs in the plant accounts because these accounts provide the basis for cost recovery through the ratemaking process." Letter dated Feb. 24, 1999 from William E. Kennard, to Hon. W.J. Tauzin and John D. Dingell, attachment at 3 ("Feb. 24, 1999 FCC Letter to Congressmen Tauzin and Dingell"). Of course, a presumed incentive is no reason for an auditor to skip half of the procedures required to

Second. The huge margin of error in the dollar estimates discussed above makes it impossible to rely on the auditors' estimates. A 40% to 50% margin of error is certainly too imprecise to justify any CPR or accounting adjustments – even if that were the only flaw in the auditors' method. And, in view of the fact that no single value within these wide ranges is any more likely to be correct than any other, auditing standards such as those used by the IRS¹⁶ would use the low end of the confidence interval. And, EY recommends using a 99%, rather than a 95%, confidence interval “to balance the bias that is inherent in the audit.”¹⁷ The use of a more conservative 99% interval is especially necessary given the significant uncertainty created by the sample design that does not consider dollar values. As a result of these corrective adjustments alone, the auditors' estimates are reduced from \$499 million to about \$180 million for Pacific Bell and from \$221 million to about \$-40 million for SWBT.¹⁸ If, in addition, one considers that the

reach an accurate conclusion. Besides, booking of costs is an operational task that is dependent on manpower, systems, supplier data, technology turnover, internal controls and similar factors. In fact, the auditor does not know how much incentive, if any, a particular carrier has and whether its employees' actions would, in fact, be driven by that incentive. Further, there are many variables other than motive that could affect the accuracy of bookings, such as the accuracy of data furnished by suppliers. Thus, the auditor cannot assume the nonexistence of half of the equation, especially without reviewing and testing internal controls as part of the audit. Even if such an incentive could play a role, the FCC's response fails to consider the significantly reduced incentive for carriers to be concerned about booked costs because of price cap regulation without rate-of-return backstop mechanisms. Under this form of regulation, there is no expectation of cost recovery through a ratemaking process as discussed under Issues 8 below.

¹⁶ EY Pacific Report at 11; Bell Atlantic Response at 11; US WEST Response, Attachment 2, Letter from Ann Thorton, Deloitte & Touche, dated Aug. 18, 1998, at 3.

¹⁷ Bell South Response at 21. *See also* EY Pacific Report at 11-12.

¹⁸ The auditors use the midpoint of the confidence interval as their estimate of the plant balance overstatement (\$499 million for Pacific Bell and \$221 million for SWBT). For the reasons discussed in the text, EY uses a one-sided lower confidence bound which

number of items considered "not found" should have been reduced from 198 to no more than 106, based on the evidence the SBC LECs submitted, the low end of these confidence intervals would be below zero for both SWBT and Pacific Bell.¹⁹

Third. The other sources of bias further undermine the value of the estimates. While it is hard to quantify the impact of these bias factors, their impact should not be ignored. For example, bias is introduced by the auditors' poorly planned and conducted field audits, and subsequent procedures. A number of factors contributed to this nonsampling error, such as the lack of training and coordination among the FCC audit teams; lack of consistent, written guidelines for handling problems or contingencies in the field; failure to provide practical written field instructions; failure to have a complete understanding of the SBC LECs' practices, procedures and controls prior to conducting the field visits; failure to review the SBC LECs' SAVR inventory process as part of this audit; the significant number of changes in the field results soon after the field work but without going back to any locations to check the quality of the initial field work; the substitution of locations that were deemed impractical to audit and of items that were deemed "hard-to-get-to"; the failure to allow sufficient time to conduct a thorough review of all 36 items at every location; and the lack of consistent, contemporaneous written guidelines for rescoring field results based on evidence submitted by the audited RBOC.²⁰

To illustrate just one of these sources of bias, consider the rescoring by the auditors during the field audits and shortly afterwards back at the FCC offices. Often, the

yields \$180 million for Pacific Bell and \$-40 million for SWBT. EY Pacific Report at 11-12 & 21.

¹⁹ EY Pacific Report at 21.

²⁰ For further discussion of these sources of bias, see SBC LECs Response at 11-17.

two auditors would consult with each other during the field audit to revise scores. Then, back at the FCC offices scores were revised again. In this post-field audit rescoring, over 12% of the items were rescored across all the audit teams that audited the SBC LECs and one of the audit teams had over 45% of its scores revised back at the FCC offices.²¹ These facts indicate that the standards of review were ill-defined or not defined at all in advance. Further, it is not quite as troubling that the auditors revised their scores on-site while they could still visually check the equipment as the fact that the auditors made numerous changes based on their notes alone back at the office. At a minimum, the auditors should have returned to a sub-sample of locations to determine whether changes were being made appropriately.²² As EY explains,

The audit staff tried to correct this control problem by making extensive "back-at-the-office" changes in the scores. It is unclear whether they succeeded in addressing the original team variability in approach since no locations were revisited to verify that the back office scoring correctly represents the true state of the property records.²³

While the impact of these sources of bias on the audit results cannot be precisely measured in all cases, the degree of difference between the auditors' scores and the audited companies' scores reflects the amount of bias inherent in the auditors' procedures. For instance, the following are the number of items scored as "not found" by the auditors compared to the RBOCs' own documented findings:

²¹ SBC LECs Response at 15 and Attachment A.

²² See SBC LECs Response at 15 and Attachment B, at 3; BellSouth Response at 12.

²³ Bell Atlantic Response, Exhibit 2, at 5. Other reasons exist to make a second visit, such as the unavailability of supporting documentation for some items at the time of the field visit. Given the difficulty of furnishing documentation for one of thousands of line items on a couple of hours' notice on the day of the field visit, the auditors should have been more willing to accept documentation submitted after the field visit.

	<u>FCC "Not Found"</u>	<u>Difference</u>	<u>BOC "Not Found"</u> ²⁴
SBC LECs	198	92	106
Ameritech	140	32	108
BellSouth	116	32	84
US WEST	123	75	48

As these numbers show, there is a significant difference in the number of line items, and the difference is even greater if one considers the value of items "not found." The greater difference in the dollar values is due in part to the greater incentive that the audited RBOC personnel have to find higher value items. As an example, for Pacific Bell, the difference between the auditors' scores and the company scores reduces the auditors' estimate by about \$375 million, a 75% reduction, compared to about a 50% reduction in the number of items (from 113 to 58).²⁵ When the disparity between two sets of results is this large, standard auditing procedures prescribe that additional procedures be performed to obtain adequate assurance regarding the auditors' conclusions. Thus, the FCC auditors should have sought to discuss their preliminary results with the companies and obtained clarification of the documentation submitted. Strangely, however, in this audit, the FCC auditors made no attempt to discuss the SBC LECs' write-ups with company personnel. Failing to obtain sufficient evidence or information to resolve conflicting data is contrary to Generally Accepted Auditing Standards and further demonstrates the bias inherent in this audit.²⁶

²⁴ The sources of these numbers are the RBOCs responses.

²⁵ EY Pacific Report at 16.

²⁶ In fact, instead of seeking to discuss and obtain further information about the documentation that the SBC LECs were submitting, the FCC auditors attempted to cut off further submissions before the SBC LECs had an adequate opportunity to research and respond to the preliminary results of the field visits. See Letter dated Jan. 27, 1998 from

Fourth. In addition to being inflated and utterly unreliable as a result of the foregoing flaws in audit methodologies and procedures, the auditors' estimate of the value of "missing" equipment they would have the companies write off is exaggerated because it does not consider the impact of accumulated depreciation. That is, the audit reports' figures are too high because they are stated in terms of gross, rather than net, book value. Specifically, the gross book value of the 198 items the auditors classified as "not found" at the SBC LECs was \$1.9 million compared to a net book value of \$746,000 for these same items. This represents a 60% reduction in the face value of the amount of equipment considered not found. By using gross book values to extrapolate the results, the FCC auditors further overstated the significance of the potential discrepancies.

Even the Florida Public Service Commission ("Florida PSC") recognizes that "the validity of the sample was compromised" and concludes that "the sample results should not be extrapolated to the population."²⁷ In fact, the Florida PSC notes that another problem with the sample design is that it was not designed to produce accurate estimates at the state level.²⁸ While each of the audit reports was careful to point out that "all of the states in which [the RBOC] operates were represented in the sample,"²⁹ the auditors did not properly design the sample to be representative by state. For example, as the Florida PSC explains, the auditors added a single central office location in North Carolina after the fact.³⁰ If the auditors wanted results that could be used at the state level, they should

Ken Ackerman, Chief, Audits Branch, FCC to B. Jeannie Fry, Director—Federal Regulatory, SBC.

²⁷ Florida PSC Comments, CC Docket No. 99-117, filed June 7, 1999, at 3.

²⁸ *Id.*

²⁹ *See, e.g.,* Bell Atlantic (South) Audit Report, Appendix B, at 6(emphasis added).

³⁰ Florida PSC Comments, CC Docket No. 99-117, filed June 7, 1999, at 3.

have used a method such as state stratification. The Florida PSC finds this problem because of the omission of North Carolina in the initial sampling results for BellSouth, but it is not an isolated problem. As the SBC LECs Response explained, this problem is also evident in the auditors' handling of Oklahoma and Nevada in the SBC LECs' region.³¹

The sample results simply cannot be accurately extrapolated to the entire population. As the foregoing shows, after compensating for the severe deficiencies in the sampling methods and using the companies' corrected scores for the "not found" items, the resulting dollar estimate for the "not found" items are very low or below zero. In view of these deficiencies and the highly uncertain audit results, it is apparent that the audit results are extremely unsound and cannot be relied upon for any purpose.

B. The Poorly Explained Bayesian Method Cannot Remedy the Fundamental Flaws in the Sample Design and Audit Procedures.

Much like the auditors' other after-thoughts, the brief and ill-defined description of the auditors' Bayesian statistical analysis was added to the second draft of the audit reports that were furnished to the companies near the end of 1998. The audit reports explain that this Bayesian analysis was added to corroborate the auditors' original findings that used a classical statistical analysis,³² but, it would be more precise to say the Bayesian analysis was added in response to the RBOCs' criticisms of the classical statistical analysis in the July 1998 draft audit reports. In Appendix B of the audit reports, the one-page description of the FCC auditors' Bayesian analysis is much shorter than the step-by-step fifteen-page description of their classical analysis. Whereas formulas and step-by-step procedures are included for their classical analysis, very little

³¹ SBC LECs Response at 16-17.

³² See, e.g., SWBT Audit Report, Appendix B, at 16.

information is included regarding their Bayesian analysis. In fact, because there is not just one Bayesian procedure, but a whole family of Bayesian approaches, the auditors' corroborating analysis cannot be evaluated by another statistician. As EY explained the problem with the auditors' Bayesian analysis:

[The auditors'] claim that the Bayesian analysis corroborates their initial results is, however without foundation. No information regarding important aspects of the Bayesian analysis is given in the FCC's draft report. None of the claims made concerning how Bayesian methodology eliminates bias and other problems in the initial analysis are justified. And final results are given without any discussion of how they were derived. Thus, an unsubstantiated Bayesian analysis, using data containing biases, is being used to corroborate the staff's flawed initial analysis.³³

US WEST's consultant, Deloitte & Touche, likewise concluded that "it is impossible to evaluate the Bayesian results presented in the December ASD Report."³⁴ Ameritech's consultant also complains that the "exact procedures used in the Bayesian analysis were not explained or revealed in this report."³⁵

This is precisely the sort of conduct that earns the auditors' activities credit as a "game of Gotcha!"³⁶ as described by Commissioner Furchtgott-Roth. By not disclosing the details of the Bayesian analysis, the auditors make it impossible for the RBOCs to challenge the analysis directly. Instead, the auditors can represent to the unwary reader that the audit results have been "independently" confirmed by a separate statistical analysis. But, there was nothing "independent" about this Bayesian analysis, as it relied

³³ SBC LECs' Response, Attachment B, at 3.

³⁴ US WEST, Attachment 2, Jan. 8, 1994, at 4.

³⁵ Ameritech Response at 7.

³⁶ NOI, Separate Statement of Commissioner Furchtgott-Roth, Dissenting in Part at 3.

upon all of the same flawed data and poorly designed sampling as the original analysis. “Like any other model, the outputs are only as valid as the inputs and assumptions.”³⁷

The SBC LECs question the auditors’ statements regarding the advantages of its Bayesian analysis, especially as applied in the context of these audits. However, it is difficult to provide any details to back up this challenge when the auditors play “hide and seek” with the audited companies. While the SBC LECs would like to review the details of the FCC’s Bayesian analysis so that they could have an independent statistician evaluate it thoroughly, the SBC LECs do not see how this analysis could ever overcome the significant flaws in the data and audit methodologies, sample design, etc. In an Attachment to BellSouth’s Response,³⁸ EY rebuts some of the FCC auditors’ specific assumptions concerning its Bayesian analysis, including the FCC auditors’ unsubstantiated assumption that “the sample mean is the most likely estimate of the population mean.”³⁹ As EY explains, this statement “is not warranted without imposing strong conditions on the prior and the data.”⁴⁰ In effect, to properly apply a Bayesian type of analysis, one must have an initial description of the anticipated results of the analysis, which may be based on prior experience. This initial description or “prior” is then combined with the sample data to produce final results. Because any attempt to predict the most likely number – if such a prediction is even possible – depends on the initial description of the anticipated results, deficiencies or uncertainty in the initial

³⁷ Bell Atlantic Response, Exhibit 2, at 6.

³⁸ BellSouth Response, Attachment at 5-6.

³⁹ SWBT Audit Report, Appendix B, at 16.

⁴⁰ BellSouth Response, Attachment at 5-6

description will make it inappropriate to make any claims about the most likely number in the final results.

Thus, here, the auditors' unexplained Bayesian analysis provides nothing more than a false sense of security, as it does nothing to fix the original, classical analysis.

II. The SBC LECs Furnished Sufficient Evidence of the Existence of "Not Found" Items, Which the Auditors Rejected Without Any Explanation (Issue 2).⁴¹

In their responses, all of the RBOCs complained about the procedures used by the auditors to determine whether an item was found during or after the field audits. Bell Atlantic states:

[T]he audit staff reports essentially ignore the documentation and other back-up materials that Bell Atlantic submitted to demonstrate that it was able to identify the overwhelming majority of the equipment that was missed in the initial inspections. . . Without any explanation at all, the draft reports nearly doubled the value of the items classified as missing compared to the original audit results.⁴²

Similarly, US WEST complained that the auditors "made no attempt to verify any of the detailed information that US WEST submitted on all sample items that [the auditors] identified as 'not found.'"⁴³ Likewise, Ameritech complained that its supporting "documentation was apparently not fully taken into account in the December Report.

⁴¹ Nothing in this section or in Exhibit "B" is intended to waive the SBC LECs' arguments in their Application for Review of the Bureau's July 27, 1999 ruling on MCI's Freedom of Information Act request (FOIA Request Control No. 99-163). MCI should not be allowed access to raw audit data or auditors' workpapers, contrary to the FCC's long-standing policy of protecting this information.

⁴² Bell Atlantic Response at 10.

⁴³ US WEST Response at 7.

The [auditors] changed very few items to a found designation based on additional supporting documentation.”⁴⁴ In their Response, the SBC LECs specifically complained that each of the audit reports of the SBC LECs:

- (1) improperly rejected the evidence of the existence of items;
- (2) failed to explain the auditors’ reasons for rejecting proof of the existence of many items;
- (3) failed to describe the auditors’ standard of proof for rescoring items; and
- (4) failed to explain why the auditors neither sought additional information nor reinspected any locations.⁴⁵

Now, for the first time, in the April 7, 1999 Public Notice,⁴⁶ the auditors have furnished some guidelines for the RBOCs’ requests to rescore the late 1997 field audit findings. The SBC LECs received the preliminary field audit findings in November 1997. Certainly, the SBC LECs could have followed these guidelines if the auditors had furnished them with the preliminary field audit findings or in early 1998.⁴⁷ But, after the fact, these guidelines represent merely an attempt to rationalize the field audit results.

⁴⁴ Ameritech Response at 5.

⁴⁵ SBC LECs Response at 23-24.

⁴⁶ Public Notice, DA 99-668, released April 7, 1999 (the “Rescoring Public Notice”).

⁴⁷ Given that the auditors requested responses within about two weeks of providing the preliminary results, the guidelines should have been furnished at the same time, rather than seventeen months later.

These rescoring guidelines raise a number of serious concerns discussed in the letter from EY regarding the rescoring standards attached as Exhibit "B" to these Comments.⁴⁸ Some of these concerns are discussed below.

The Rescoring Public Notice states that the "type and quality of evidence submitted by the companies was not consistent, however, and often did not meet the standards to warrant rescoring."⁴⁹ The SBC LECs do not understand how the auditors can reasonably expect the evidence to meet standards that are released for the first time about seventeen months after the fact. Obviously, the RBOCs could not meet these standards in late 1997 or in 1998, as they did not obtain the standards until four months into 1999. And, nowhere does the Public Notice contend that the audited companies were given these standards before April 7, 1999, nor does the Rescoring Public Notice even contend that these standards existed in written form prior to the preparation of the Public Notice.⁵⁰ For all we know, the auditors formulated the standards after receiving all the evidence, or perhaps, only after being asked to do so in response to the joint letter from Congressmen Tauzin and Dingell⁵¹ or the RBOCs' complaints about the auditors' procedures. In any event, it is fundamentally unfair to formulate standards after the fact

⁴⁸ Letter dated July 14, 1999 from John Putnam, Partner, Ernst & Young to B. Jeannie Fry, Director—Federal Regulatory, SBC ("EY Letter Regarding Rescoring Standards"), attached as Exhibit "B" to these Comments.

⁴⁹ Rescoring Public Notice at 2 (emphasis added).

⁵⁰ In fact, it appears that these standards did not exist in written form previously because they were not provided by the FCC in response to a request from Congress. See Feb. 24, 1999 FCC Letter to Congressmen Tauzin and Dingell at 2-3 (Letter from Congress asked the FCC to "provide the written standards used to evaluate the evidence collected" but the FCC did not furnish any written standards.)

⁵¹ Letter dated Jan. 27, 1999 from Hon. W.J. Tauzin and John D. Dingell to William E. Kennard.

to support the previous findings when the audited companies were never before given these standards.⁵²

In fact, the auditors never defined these standards for the SBC LECs, nor did the auditors explain to the SBC LECs their reasons for rejecting almost all of the over 200 write-ups that the SBC LECs submitted. And, if the auditors truly considered these to be deficiencies at the time, the SBC LECs would have expected the auditors to communicate these deficiencies to the SBC LECs at some point during the several months during which this evidence was submitted to the auditors.⁵³ Instead, despite repeated requests for earlier feedback, the SBC LECs did not discover the results of their efforts to correct the results until they received the draft reports in July 1998, and even then, they were left to guess why their many write-ups were rejected.⁵⁴ As EY explains, a “critical element

⁵² See EY Letter Regarding Rescoring Standards, attached as Exhibit “B” to these Comments, at 1.

⁵³ The SBC LECs sought guidance from the auditors early in the process of submitting their write-ups and specifically attempted to determine the sufficiency of the documentation they were submitting. Despite some general discussions, the auditors did not give the SBC LECs any definitive guidance or instructions. In fact, a few days after these general discussions, the SBC LECs received a letter advising them that further documentation and data would not be accepted. See Letter dated Jan. 27, 1998 from Ken Ackerman, Chief, Audits Branch, FCC to B. Jeannie Fry, Director—Federal Regulatory, SBC. While this letter was not enforced (although never retracted either), the auditors did not contact the company in response to numerous letters submitting documentation to the auditors. Typically, these letters invited the auditors to call the company representative “if you wish to discuss this further or have additional questions regarding this information.” See, e.g., Letter dated Mar. 17, 1998 from B. Jeannie Fry, Director—Federal Regulatory, SBC to Mr. Jeff Stover, Audits Branch, FCC. They should have done so if they considered the documentation to be inadequate, as the July 1998 draft audit reports ultimately revealed.

⁵⁴ Other RBOCs’ Responses noted the lack of adequate communication between the auditors and the audited company, which is inconsistent with the procedures required by Generally Accepted Government Auditing Standards (“GAGAS”). See, e.g., US WEST Response at 6-9 and Attachment 1, at 3-5.

of auditing is timely and frequent interaction with representatives of the company being audited to attempt to address issues raised in the audit.”⁵⁵

The Rescoring Public Notice recognizes that under Generally Accepted Government Auditing Standards (“GAGAS”),⁵⁶ “[e]vidence obtained through the auditor’s direct physical examination, observation, computation, and inspection is more competent than evidence obtained indirectly.”⁵⁷ However, the FCC auditors apparently cite this principle as a justification for rejecting most of the RBOCs’ evidence verifying the physical existence of substantially all of the audited items. Indicating that this is the reason for citing this principle, the Rescoring Public Notice states that the audits “are based primarily on information collected in the field” and that “the best evidence that

⁵⁵ See EY Letter Regarding Rescoring Standards, attached as Exhibit “B” to these Comments, at 1.

⁵⁶ The Rescoring Public Notice states that the FCC auditors conducted their audits under GAGAS, but those are not the correct standards to use in auditing nongovernment entities. GAGAS is intended for audits of government agencies. GAGAS does not address how to perform audits regarding the fair presentation of a company’s financial statements. Given that this was an audit of business enterprises for the purported purpose of expressing an opinion regarding the accuracy of their central office equipment account balances, the FCC auditors should have used Generally Accepted Auditing Standards (“GAAS”). See EY Letter Regarding Rescoring Standards, attached as Exhibit “B” to these Comments, at 5. In contrast, the audit of GTE’s continuing property record was performed in accordance with GAAS, according to the GTE audit report released just last year. *GTE Telephone Operating Companies; Release of Information Obtained During Joint Audit*, 13 FCC Rcd 9179, Audit Report, Part V, Audit Team Reply at 1 (1998). Actually, the auditors contend that they “are not strictly required to operate under GAGAS” either, and thus, they appear to take the position that they are not strictly required to abide by any standards in performing their audits. See Letter dated Jan. 27, 1999 from Hon. W.J. Tauzin and John D. Dingell to William E. Kennard, Attachment at 2(response to question #2).

⁵⁷ Rescoring Public Notice at 1.

verified whether an item was accurately recorded in the CPRs was the auditors' physical inspection during the field audits."⁵⁸

Given that the auditors recognized that direct physical examination was an important procedure in reaching their conclusions, it is surprising that the auditors did not return to any of the central offices to evaluate evidence provided by the RBOCs after the initial field visits. The procedures used during the initial visits were too restrictive and did not allow sufficient time to find items, much less to find, review and consider supporting documentation. And, when this supporting documentation was located and sent to the auditors after the field visits, the auditor could have verified the item by returning to the central offices. Instead, as other RBOCs note,⁵⁹ the auditors declined to return to any of the central offices. Generally Accepted Auditing Standards ("GAAS") require that "[s]ufficient competent evidential matter is to be obtained through inspection, observations, inquiries, and confirmations to afford a reasonable basis for an opinion . . ."

The auditors would have been able to verify additional items by direct physical examination if they had returned to the central office after receiving the write-ups and supporting documents furnished by the SBC LECs. As Arthur Andersen observes, the auditors needed to consider additional procedures such as return visits to the central offices "in order to derive complete and accurate audit results."⁶¹ This same principle of auditing is explained and illustrated by an example in the letter from EY attached as

⁵⁸ Rescoring Public Notice at 1-2.

⁵⁹ See, e.g., Bell Atlantic Response at 4.

⁶⁰ AICPA, Statements on Auditing Standards, AU Section 350.04, Audit Sampling.

⁶¹ Ameritech Response, Appendix A-O, at 3 (citing AICPA, Statements on Auditing Standards, AU Section 350.25, Audit Sampling.)

Exhibit "B."⁶² The example used by EY was an item called a "remote test port" that Pacific Bell's engineers located the day after the field visit, but the FCC auditors refused to make a return visit to verify the item and, without further inquiry, also rejected documentation showing the existence of the item. Another similar applicable principle of GAAS is summarized by Arthur Andersen as follows:

GAAS require that, when an auditor becomes aware of information subsequent to the issuance of the audit report that would have prompted the auditor to investigate the information had it been known, the auditor must determine whether the information is reliable and whether the facts existed at the date of the audit report.⁶³

In light of the evidence submitted by the SBC LECs that showed that items were found, the auditors did not have sufficient evidence to form a conclusion that these items were "not found." Here, the auditors did nothing to determine whether the facts existed as shown in the documentation submitted by the SBC LECs other than to apply secret standards to reject the documentation that it deemed insufficient. It applied these secret standards without further examination even though its on-site physical examination had not been adequate to evaluate the facts presented in the SBC LECs' documentation.

The GAAS standards for fieldwork contain another principle that demonstrates the importance of performing additional procedures, especially when the procedures that have been applied so far yield conflicting evidence. This portion of the standards states:

[T]here will be circumstances when inquiry and analytical procedures (a) cannot be performed, (b) are deemed less efficient than other procedures, or (c) yield evidence indicating that the assertion may be incomplete or

⁶² EY Letter Regarding Rescoring Standards, attached as Exhibit "B" to these Comments, at 3.

⁶³ US WEST Response, Attachment 1, at 4 (citing AICPA, Statements on Auditing Standards, AU Section 561: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report).

inaccurate. In the first circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.⁶⁴

In all three situations, GAAS recommends additional procedures. However, in these audits, the auditors chose not to perform additional procedures necessary to evaluate the companies' detailed, factual opposition to the preliminary field audit results.

Putting on blinders in this fashion is also contrary to the GAAS requirement that auditors consider all appropriate evidence in reaching a conclusion. The auditors did not consider all of the documentation submitted by the SBC LECs.⁶⁵ For example, the auditors did not consider evidence showing that an item had been retired if the documentation was not in the exact form required by its standards released seventeen months after the preliminary results. Mechanized order acknowledgments generated by a third party vendor clearly should be considered sufficient, but the Rescoring Public Notice now indicates that the vendor invoices are required. Nor should internally generated documents be dismissed summarily since they are the products of internal systems and controls that the auditors did not even bother to test.

Likewise, the auditors did not consider evidence that an item was actually found if certain details in the CPR did not match information on the supporting documents, such as invoices, or what the auditors observed during the field visits. The auditors rejected information that was not an exact match even if the nonmatching data was explained in detail. In some cases, the equipment descriptions did not match exactly for one reason or

⁶⁴ AICPA, Statements on Auditing Standards, AU Section 2010.41, Standards of Fieldwork(emphasis added).

⁶⁵ See EY Letter Regarding Rescoring Standards at 3.

another, but the auditors simply rejected the explanations of nonmatching descriptions, without further inquiry. For example, the SBC LECs explained that a description did not match because Bellcore had assigned a single CPR number to multiple part numbers. In its response to the audit reports, Bell Atlantic noted the same difficulty persuading the FCC auditors to accept reasonable explanations for nonmatching descriptions.⁶⁶ Another example, described in the letter from EY attached as Exhibit "B", were 48-volt battery racks mislabeled in the CPR as 24-volt battery racks. Despite a detailed explanation, the FCC auditors did not alter their conclusions or make any further inquiries.⁶⁷ In another case, the SBC LECs explained that the vendor supplying the equipment had failed to include correct information in the mechanized equipment order that automatically updates the CPR.⁶⁸ In all of these cases, the equipment existed but the auditors failed or

⁶⁶ Bell Atlantic at 6 ("Such differences should not be unexpected given the nature of the property record system. Even aside from the potential for a minor error in inputting the information, the property records systems themselves automatically include a description based upon an item's continuing property record identification number. If multiple descriptions are available for a particular identification number, absent direct manual override, the property record will always display the first choice in the list. Nonetheless, Bell Atlantic was able to confirm that the record and the equipment that it found were indeed a match by relying upon its supporting documentation - just as the Commission's rules themselves contemplate.")

⁶⁷ EY Letter Regarding Rescoring Standards, at 3.

⁶⁸ In fact, in the 1994 audits of Pacific Bell, the FCC auditors had recognized the possibility of errors caused by vendors, especially when the vendor was a company other than AT&T, which had designed and was most familiar with the mechanized property record system. See Letter dated April 11, 1994 Jose Rodriguez, Chief, Audits Branch, FCC to Sheryl L. Herauf, Pacific Telesis at 7-8 ("CPRs for . . . equipment purchased from various manufacturers other than AT&T are also deficient in that they do not provide an adequate description of the equipment to enable a positive identification from the records.").

refused to accept what the documents showed or to perform additional procedures to confirm its existence.⁶⁹

The Rescoring Public Notice also shows that the auditors' standards during the field visits were unreasonable. For example, the auditors apparently expected the RBOC employees to have engineering drawings or manufacturer schematics available for each and every one of the thousands of embedded items in the central office in case an embedded item was on the list of 36 selected items.⁷⁰ Not only did they expect these drawings to be available, but they expected the RBOC employee to find these documents in a matter of minutes and to provide a complete explanation.⁷¹ Otherwise, the Rescoring Public Notice indicates that it would be practically impossible to persuade the auditors to rescore an item after the fact. In fact, the auditors' standards apparently did not permit

⁶⁹ Bell Atlantic describes similar situations in its Response:

For example, one selection was described as panel boards, but was in fact fuse boxes that included a panel board as a component. This was verified by referencing the supporting invoices for the items. Such differences should not be unexpected given the nature of the property record system. Even aside from the potential for a minor error in inputting the information, the property records systems themselves automatically include a description based upon an item's continuing property record identification number. If multiple descriptions are available for a particular identification number, absent direct manual override, the property record will always display the first choice in the list.

Bell Atlantic Response at 6.

⁷⁰ See Rescoring Public Notice at 4 ("If the company representative provided evidence (e.g., an engineering drawing or a manufacturer schematic) demonstrating that this was true, the auditor classified the item as 'found.' If no such evidence was provided during the field audit, but a credible claim was made that the equipment was embedded in other equipment present, the item was scored as 'unverified.'"(emphasis added)).

⁷¹ In some cases, the auditors apparently even expected the SBC LECs to shut down a switch processor and disassemble it to locate an item, even though this would have interrupted or disrupted service. In any event, the auditors did not allow a sufficient number of hours to undertake that type of exhaustive search.

items initially scored as “not found” to be re-scored as “found” based on evidence that they were embedded.⁷² To explain, the Rescoring Public Notice states as follows:

If the companies provided documentation (*e.g.*, an engineering drawing or manufacturer schematic) that showed that an item initially scored as “unverified,” functioned by design within another item listed on the frame, the item was re-scored as “found.”⁷³

Thus, embedded items that were initially scored as “not found” had no chance of being re-scored as “found” no matter what evidence was presented after the field audits.⁷⁴

Not only were the rescoring standards flawed for all of the above reasons, they were also applied in an inconsistent fashion. As explained in the attached EY letter (Exhibit “B”), even when exactly the same or very similar documentation was furnished on two different items, the auditors reached opposite conclusions.⁷⁵

In summary, there were serious problems with the FCC auditors’ approach to rescoring. It is fundamentally unfair to judge the sufficiency of documentation by standards released long after the fact. Also, ignoring a critical element of auditing, the

⁷² See EY Letter Regarding Rescoring Standards, attached as Exhibit “B” to these Comments, at 4 (“Additionally, for embedded items, Ernst & Young determined the FCC’s rescore criteria to be too limited.”).

⁷³ Rescoring Public Notice at 4 (emphasis added).

⁷⁴ Apparently, the only limited exception was for items embedded within equipment that the auditors had actually observed during the initial field visit. However, if the company representative was unable to determine where the item was embedded in the limited time of the initial field visit, the “not found” conclusion apparently became immutable. The Rescoring Public Notice states “Generally, a claim was considered credible if the other equipment listed for the same frame was found to be in place as listed.” The auditors would have found the other equipment in which the item was embedded if they had simply made a return visit to the central office location, assuming they were not going to accept documentary evidence.

⁷⁵ See EY Letter Regarding Rescoring Standards, attached as Exhibit “B” to these Comments, at 2.

auditors failed to perform additional procedures such as discussions with company employees, requests for clarification of complex, technical information, requests for further documentation or return visits to central offices. In addition, they did not even adequately consider the documentation that was submitted because, for instance, they insisted that it had to be in the exact format required by its rescoring standards when they should have considered additional types of documents that were submitted. Many items had little or no chance of being rescored such as embedded items initially scored as "not found." On top of all of these problems, when the rescoring standards are compared to the audit results, the results are inconsistent, such as opposite conclusions on the very same evidence.

Using these unfair and inconsistent procedures, the auditors improperly rejected the SBC LECs' proof that dozens of the items they had classified as "not found" actually existed. In effect, the SBC LECs showed that, on an investment basis, the "not found" items should have been reduced to 3 % of the sampled investment, if not lower. In view of the unfairness and inconsistency of the auditors' field audit and rescoring procedures, and especially the fact that the rescoring standards were not released until many months after the fact, the audit results should be rejected in their entirety.

III. Serious Deficiencies in These Audits Prevent Them from Serving as a Basis to Require Corrective Action (Issue 3).

As the SBC LECs have shown above and in their Response, there are serious flaws in the audit procedures and statistical methodologies used by the auditors and the audit findings are contrary to the evidence submitted by the SBC LECs but largely ignored by the auditors. According to the other RBOCs' response, their audits were